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USTR FOR STRATFORD, MCCARTIN, KEMP, BELL

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TAGS: AS CH ECON EINV EIND EMIN ETRD PGOV
SUBJECT: CHINA/AUSTRALIA: CHINALCO,S RIO TINTO BID: A NATIONAL CHAMPION "GOES OUT" TO "LOCK UP" RESOURCES

REF: A. REF A: CANBERRA 00143
¶B. REF B: CANBERRA 00180
¶C. REF C: 2008 BEIJING 389

Classified By: Economic Minister Counselor Robert S. Luke for Reasons 1.4 (b/d).

Summary

¶1. (C) The state-owned Aluminum Corporation of China (Chinalco) announced February 12 a USD 19.5 billion bid for a bigger stake in select assets of Anglo-Australian mining giant Rio Tinto, in which it is already the largest shareholder (Refs A and B). If approved, the deal would be the largest-ever overseas acquisition by a Chinese firm. Australian approval of the transaction will focus on Chinalco's state ownership, competition concerns, and reciprocal access to investment opportunities in China's natural resources sector. Chinalco's pursuit of Rio assets illustrates Beijing's "Go Out" (zouchuqu) policy, which encourages leading Chinese firms to invest abroad to secure access to natural resources, brands, distribution channels, and management expertise. The bid would also advance Beijing's goal of accelerating the formation of internationally competitive, state-controlled national champions in what it considers to be key "strategic" sectors. End Summary.

Chinalco to Increase Stake in Rio Tinto

¶2. (U) Chinalco announced February 12 that it would pay USD 7.2 billion for convertible bonds in Rio and separately invest USD 12.3 billion to acquire minority stakes in select Rio mining assets, including iron ore, copper, and aluminum fields. If approved, Chinalco's effective stake in Rio would double from nine to 18 percent. Rio Tinto is seeking to raise capital to scale back the leverage it built up during the commodity boom and views the deal as a lifeline.

¶3. (U) A well-regarded China-based consulting firm, Dragonomics, has assessed that the proposed deal would give Chinalco a strong degree of influence over Rio's copper, iron ore, and aluminum operations, if not outright control, via the joint strategic alliances that would be formed to manage those assets. In contrast, respected local finance journal Caijing Magazine reports that Chinalco's motivation for pursuing Rio is partly a desire to block a rumored possible competing bid from rival BHP Billiton. Caijing reported that

Chinalco feared that a combined BHP-Rio would have the scale to set prices for key resources that China needs.

¶4. (U) Chinalco's Rio bid is only the highest profile proposed Chinese acquisition in Australian natural resources assets. In addition, China Minmetals signed a February 16 contract with Oz Minerals, which like Rio is also plagued with high debt; Chinese steel and iron maker Hunan Valin Iron and Steel Group agreed on February 24 to invest USD 776 million for a stake in Fortescue Metals Group (FMG), Australia's third-largest iron ore producer; and China Investment Corp (CIC), China's sovereign wealth fund, is reportedly also in talks with FMG to help it retire debt.

¶5. (C) Chinalco declined repeated requests to meet with Embassy officers to discuss its bid.

Rio Deal would Promote Development of a State-Controlled "National Champion"
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¶6. (C) While the State-owned Assets Supervision and Administration Commission (SASAC) has told us repeatedly that China's SOEs operate commercially and that its function is to administer them, not to make policy, Chinalco's bid appears designed to fulfill several goals laid out by the State Council and/or SASAC. First, Chinalco's bid would advance China's goal of encouraging SOEs to concentrate and develop international competitiveness in "key sectors" where the state is seeking to maintain or strengthen its control. This goal was enunciated in a December 2006 State Council "Opinion" on SOE restructuring that was drafted by SASAC.

The document encourages "predominant" SOEs to concentrate and strengthen international competitiveness in these "key fields," which include the natural resources sector.

¶7. (C) Indeed, the promotion bestowed on Chinalco's CEO following the latest bid illustrates the importance China attaches to ensuring SOEs aim to achieve those goals. Specifically, a week after proposing the latest Rio bid, Chinalco CEO Xiao Yaqing was tapped as the new Deputy Secretary General (DSYG) of China's State Council, a key staff position in China's highest executive organ. An illuminating contrast to Xiao's promotion is the forced resignation of former CAAC Minister Yang Yuanyuan. Yang was pushed out in December 2007 because the State Council and SASAC were reportedly displeased with his support for Singapore Airlines' proposed acquisition of a 24 percent stake in China Eastern Airlines when the State Council and SASAC instead favored a tie up between Air China, China Eastern, and China Southern (Ref C). Civil aviation is another sector that the State Council identified for maintained or enhanced state control.

China Tells Firms to "Go Abroad" to Secure Resources
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¶8. (C) In addition to encouraging SOEs to concentrate in key fields, Beijing also encourages "capable" firms to invest abroad. While China has maintained a "Go Out" policy (zouchuqu) since 2006, recently, officials and commentators have sought to encourage and discourage outbound investment in specific sectors. For example, Caijing Magazine reported in March 2009 that SASAC encourages Chinese firms to take advantage of depressed global commodity prices to buy the hard assets that fuel China's growth. In contrast, SASAC reportedly discourages manufacturing acquisitions abroad, including in the auto sector, based on the view that manufacturing asset prices are likely to fall further. CIC has also reportedly revised its outbound investment strategy to stay away from "risky" financial sector direct investment.

State-owned Entities to Provide Financing

¶9. (U) According to numerous press accounts, the China Development Bank (CDB), the Export-Import Bank of China (EXIM

China), and/or SASAC may offer financing for the bid. EXIM, a wholly state-owned financial institution, is a policy bank and plays an important role in financing large-scale Chinese exports and infrastructure projects around the world. CDB, another policy bank in the process of reorganizing itself as a state-owned commercial bank, helped finance Chinalco's first Rio stake. Some observers speculate that CDB could sit out financing this investment, due in part to the steep fall in Rio's stock value over the past several months, which has resulted in big losses on Chinalco's balance sheet. The possibility of central government financing via SASAC has also been mooted in the press.

Australia's Foreign Investment Review Process

¶10. (C) As reported in reftels, Australia's Foreign Investment Review Board (FIRB) will make a recommendation on the deal to Treasurer Wayne Swan, who will make the final decision to approve as proposed, reject, or approve with conditions. Tony Loo (protect), Managing Director of Rio Tinto China, told Econoff that following Chinalco's first bid for a Rio stake, which had surprised Australia, Swan had released the following guidelines for evaluating future foreign-led investments:

-- The investor's independence from the relevant foreign government;

-- The investor's behavior under the law and "common standards of business behavior;"

-- The impact of the investment on competition;

-- The impact on government revenue and policies, including tax;

-- National security; and

-- Whether "an investment may impact on the operations and directions of an Australian business, as well as its contribution to the Australian economy and broader community."

¶11. (C) Loo assessed that the FIRB would have to weigh its concerns against the prospects of a traumatic downsizing at Rio and associated job losses, noting that mining requires constant investment, even during downturns. He said "the Chinalco deal would enable Rio to recapitalize and secure a better credit rating," seeing the company through a "gloomy" demand outlook.

Deal Structured to Skirt Australian Security Review

¶12. (C) Loo said that, at the time of the original deal, FIRB had recommended that Chinalco limit ownership of Rio to 14.99 percent. Loo said that Rio and Chinalco had worked to structure the new deal to meet the six principles "as best as they could" to avoid a harsh spotlight. Caijing's latest cover story reports that Chinalco officials had been in contact with Australian regulators before the deal's signing, and that they were not surprised when Treasurer Swan announced that even the convertible bonds would be viewed as shares. (Comment: U.S. officials have repeatedly advised Chinese officials and investors to be transparent in dealing with the Committee on Foreign Investment in the United States (CFIUS) by seeking pre-filing consultations and not attempting to structure deals to avoid scrutiny. It seems China is taking to heart admonitions to pre-consult, but still wants to avoid formal reviews at all costs, whether in Australia or the U.S. Chinalco also declined to discuss the transaction on several occasions with Embassy officials. End Comment.)

Deal Could Prove Challenging; Reciprocity Concerns

¶13. (SBU) John Dawkins, former Australian Treasurer and founding Director of Government Relations Australia told a combined Chinese and expatriate audience at a Beijing forum February 19 that investment in Australia by foreign SOEs and governments raises questions about whether the investors would operate solely on a commercial basis or reflect political motivation. For example, would Chinalco push to sell ore at below-market rates to other Chinese SOEs? Although hesitant to make bold predictions, Dawkins said he thought the deal would be approved, but possibly delayed. He added that Australian businesses have also been vocal about the difficulties they face investing in China's mining sector.

¶14. (C) Australian Embassy Second Secretary Caty Riordan agreed that the deal raised the question of reciprocity. If an Australian company wanted to make a similarly substantial investment in the extractive industries in China, China would be unlikely to approve it, she explained. Loo said China has not allowed Rio to look for mineral resources in the areas where Rio "would be likely to find them." (Note: Many of these restrictions are detailed in China's "Guidance Catalogue for Foreign Investment," which was most recently updated in December 2007. End Note.) Garrick Mendham (please protect), former employee of both BHP Billiton and Rio Tinto and current Technical Services General Manager of Regent Coal (BVI) Limited in Beijing, suggested that Australia's domestic politics have linked the Rio deal, as well as other Chinese investments in Australia, to reciprocal access for Australian companies in China. Mendham said he was unsure where this would lead, but did not think China would welcome a deal with Australia on reciprocity in extractive industries.

First Came Japan and Korea; Now it's China's Turn
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¶15. (C) Loo highlighted that the Japanese and Koreans faced the same dilemma in the 1960s and 1970s that China faces today: a rapidly growing manufacturing sector that voraciously consumes far more primary inputs than the country can produce on its own. The Caijing article reports that

China still only holds overseas iron ore assets equal to 10 percent of its import volume, as compared to 60 percent for Japan. In Loo's view, China's relative scarcity of natural resources (Caijing reports it produces less than half of the iron ore it uses and only a quarter of its copper needs) will make it dependent on foreign sourcing over the long-term. Geographical factors and Australia's political stability (in contrast to Africa, where China also has significant resources investments), will likely continue to attract Chinese companies to Australia. "Australia's proximity to East Asia is an equally attractive feature to the Chinese today as it was to the Japanese and Koreans years ago," Loo explained.
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